BEFORE THE
PUBLIC SERVICE COMMISSION OF WISCONSIN

Investigation on the Commission's Own Motion Regarding Innovative Utility Ratemaking Approaches that Promote Conservation and Efficiency Programs by Removing Disincentives That May Exist Under Current Ratemaking Policies

Docket No. 05-UI-114

THE RESPONSES OF THE CITIZENS UTILITY BOARD, CLEAN WISCONSIN, AND RENEW WISCONSIN TO THE QUESTIONS ASKED IN THE COMMISSION'S NOTICE OF INVESTIGATION.

The Citizens Utility Board, Clean Wisconsin and RENEW Wisconsin (the "Joint Public Interveners" or "JPI") appreciate the opportunity to submit these responses to the questions asked in the Commission's Notice of Investigation in the above entitled proceeding.[1]

I. INTRODUCTION.

The JPI believe that it is important to put their responses to the questions raised in the Notice of Investigation in an appropriate context. First, the recommendation of the Global Warming Task Force for the Commission to consider the issues in this docket was made in the context of helping to facilitate substantially increased efforts for energy efficiency, innovative rate designs and customer-sited renewable resources. The emphasis was on a significant increase in the implementation of such policies and actions to help reduce future greenhouse gas emissions (GHG), and to mitigate the impacts for utility customers and society of accelerating energy prices and costly infrastructure needs. This context is far different from the current environment in terms of the magnitude and nature of the expected efforts, their impacts on a utility and the resulting disincentives and/or lack of incentives for the pursuit of such policies.

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[1] These comments were prepared by George Edgar, consultant to the JPI with the exception of the JPI's response to Question 14 which was prepared by JPI's attorney, Curt Pawlisch.

Second, there is a tendency in the questions to only focus on the direct impacts of energy efficiency programs developed and administered by a utility. The Joint Public Interveners believe this focus artificially limits an appropriate identification of the nature and extent of the disincentives to the aggressive pursuit of or support for various policies by a utility. To achieve the desired results that underlie the Global Warming Task Force's recommendations will entail substantially increased public initiatives such as improved building codes and appliance standards as well as efforts by other entities to improve customer energy decision-making. These expanded public and non-utility efforts, just as the expanded utility efforts, will have meaningful consequences for utility financial interests.

The successful pursuit of all of these efforts is necessary and appropriate to achieve the significant customer and public benefits described by the Global Warming Task Force and would greatly benefit from utility support. But, each of these policies and actions individually, and especially collectively, create a risk to the current financial interests of the utilities. The key to success will be to develop appropriate mechanisms that are well designed and delivered to allow customer benefits to be large enough so that sharing some of them to reduce utility risk will still leave all parties better off than if less investment had been made due to misaligned incentives.

Our responses to the following questions will explain why there is a need to adopt appropriate means to better align the private financial interests of a utility to achieving the consumer and public benefits provided by the aggressive pursuit of energy efficiency, improved rate design and improved customer-sited renewable resource policies and programs whether they are pursued by a utility, a "third party" provider such as Focus on Energy, governmental institutions or other entities.

1. Do the current rate structures of the electric and natural gas utilities in Wisconsin contain a net lost revenue and profit effect that is significant enough to discourage utilities from developing and spending additional money on energy efficiency programs?

Yes. Every regulatory system creates a set of incentives and disincentives, some of which are deliberate and others which are unintended. Traditional ratemaking results in strong disincentives to aggressive policies and programs that can result in adverse financial impacts for utility shareholders such as energy efficiency, improved rate designs (e.g. inverted rates) and customer-sited renewable programs. The Joint Public Interveners will explain in more detail this general answer in two parts: (1) what are the disincentives (including a lack of incentive) for regulated utilities to the aggressive pursuit of cost-effective energy efficiency, improved rate designs and customer-sited renewable efforts and (2) what is the strength of those disincentives for Wisconsin utilities.

A. Nature Of The Disincentives And Lack Of Incentives For Aggressive Energy Efficiency, Improved Rate Design And Customer-Sited Renewable Resources For Utilities.

While there are multiple reasons why a utility may not wish to aggressively pursue energy efficiency, certain improved rate designs and customer-sited renewable resources, there are two primary barriers that are typically cited: (1) the "throughput incentive" and (2) that under traditional regulation, a utility can only earn on capital investments such as building plant which these enumerated policies defer or avoid. The first barrier is a disincentive, while the second barrier also reflects the absence of an affirmative incentive for a utility to aggressively pursue energy efficiency or other types of changes that may yield increased customer and public benefits, but are perceived as adverse to the utility's financial interest.

- **The "Throughput Incentive"**

A primary disincentive for a utility to aggressive energy efficiency, improved rate design and substantially expanded customer-sited renewable resources is sometimes called the "throughput incentive". The "throughput incentive" describes the strong incentive that traditional regulatory ratemaking creates for a utility to seek to sell more than the estimated test year sales used to establish the utility's rates.

Under traditional regulation, rates are established based on an estimate of test year sales divided into the authorized test year revenue requirement to allow the utility the opportunity to recover its authorized test year revenue requirement including its authorized return. The costs of specific interest for purposes of this question are the estimated test year "fixed costs" or "fixed margins" (which include the authorized return for utility shareholders) that do not change in the short-term with the volume of sales (i.e., these costs in the short term remain fixed whether sales go up or go down). Some portion of these "fixed costs" are recovered in the volumetric part of a rate (i.e., the per kWh or per therm elements to provide appropriate price signals) and therefore, their actual recovery is dependent on the relationship between actual sales and estimated test year sales.

All else equal, if actual sales are less than estimated test year sales for whatever reason, a utility will not earn its authorized shareholder return because some portion of fixed costs including the shareholder return will not be recovered. If actual sales exceed test year sales, the utility will over-earn its authorized return because it will collect more fixed costs than estimated to establish the test year revenue requirement. Therefore, once rates have been set and until they are reset, typically in a rate case, a utility has a strong incentive to make more sales than estimated in the test year for the financial benefit of its shareholders, bondholders and management.

While the level of actual sales is subject to forces beyond a utility's control such as weather and economic activity, actions such as aggressive energy efficiency, significant new changes in rate design or increased customer-sited renewable resources can all have the effect of reducing utility sales relative to what they otherwise would have been. These types of efforts thereby increase the potential volatility between actual sales and estimated test year sales. The "throughput incentive" discourages a utility from voluntarily and aggressively undertaking those types of activity that will result in increased risk of financial loss for its shareholders.

The direct and indirect effects of increased and substantial energy efficiency, new rate designs in which increased costs are included for recovery in the volumetric portion of the rate (i.e., inverted rates) and expanded customer sited renewable applications increase risk to the extent that their effect on sales cannot be accurately estimated when establishing test year rates. The more aggressive and wide-scale such efforts, the more difficult such estimation is likely to be. Indeed, each of the above efforts should also be expected to enhance other factors that make it even more difficult to estimate test year sales. For example, this risk is accentuated when utility efforts to help customers reduce usage to achieve more aggressive savings targets interacts with other entities taking similar actions to reduce prospective energy usage. Focus on Energy, new building codes, appliance standards, increased public initiatives to mitigate global warming and other actions by non-utility entities all have an aggregate effect that make it difficult to estimate their impact on utility sales and ultimately the risk caused to a utility of recovering its authorized "fixed costs" including return. Yet, it is this aggregate impact from these diverse actions and programs that interact to more successfully yield the substantial increased benefits to consumers and society.

While a utility return represents only a small portion of its overall costs, its recovery on the margin (i.e., in a volumetric charge) makes recovery very sensitive to changes in sales/revenues (i.e., a 1% decrease in revenue recovery will result in a larger decrease in actual ROE compared to authorized ROE). Thus, actions that may result in lower sales and corresponding lower revenues than forecast have undesirable consequences for a utility's financial interests by either resulting in under-earning or foregoing the ability to earn more than was authorized by being more cost-efficient. These adverse financial consequences provide compelling disincentives to a utility undertaking or supporting such broad, aggressive and effective initiatives even if undertaken by others.

- **Inability to Earn On Something Other Than Capital Investment**

While increased substantial actions such as energy efficiency can increase the risk of under-recovery and offset any benefits for utility shareholders gained from being more cost-efficient, they can also have the effect of displacing or deferring the only thing that utilities are traditionally allowed to earn on: capital investment needed to provide utility service. Since a utility can only earn on capital investment and energy efficiency costs are typically treated as expenses, there is an incentive to build to increase earnings as well as improve a utility's financial and business integrity under most circumstances. Actions that provide no earnings but tend to forego or defer the opportunity to build and increase earnings are not favored except in those limited circumstances where a utility perceives that building will be risky in terms of actually being able to attain a necessary level of return. This "opportunity cost" issue is concerned with where a utility will deploy resources and/or capital to provide the best results for utility shareholders, bondholders and management.

- **Other Factors That Influence A Utility's View Of Energy Efficiency**

A utility, while regulated, is still a profit-making entity whose management has a fiduciary duty to its stockholders and bondholders (as well as its own interest) to seek to increase shareholder wealth. Therefore, aggressive efforts such as energy efficiency that tend to reduce sales or the opportunity for earnings can create not only the disincentive and lack of incentive already discussed but other concerns as well including:

a. The belief that energy efficiency may not be reliable or persistent enough to meet energy needs, thus potentially adding more costs than expected benefits and possibly creating a short-term capacity or energy need "crisis" that could be more expensive to meet than would otherwise have been the case.

b. The concern about contributions to overall rate impacts that could affect sales, especially for certain price-sensitive customers, which can affect customer retention or the ability to attract new customers.

c. A potential principal-agent problem if utility management is highly rewarded for short term increases in earnings which can be threatened by energy efficiency efforts or other actions that may diminish short-term earnings opportunities, even though such actions would provide greater short- and long-term benefits to stockholders (e.g. by reducing risk by deferring risky near-term construction).

d. A concern that in a more competitive utility industry that the amount in terms of actual physical assets owned and overall financial size and strength will be key factors for success and that lower sales and less plant is not a road to success.

The presence of all of these potential factors lead to the conclusion that there is a need to better align utility financial interests with consumer and public interests if utilities are to aggressively pursue and/or support energy efficiency and other actions that are perceived by a utility as having potential detrimental effects on its financial position.

B. Extent Of The Disincentives To Wisconsin Utilities.

There are at least three important factors that are appropriate to consider when assessing the extent of the applicability of the previously identified disincentives or lack of incentives for Wisconsin utilities: (1) the level of energy efficiency and other activity; (2) the use of a third party administrator for statewide energy efficiency efforts; and (3) the lag time between when rates are set and then reset.

Current Wisconsin regulation creates the same potential disincentives or lack of incentives for a utility to support the aggressive pursuit of policies that tend to diminish sales and provide no opportunity for earnings. While Wisconsin is currently pursuing a modest energy efficiency effort, that effort is far less than is appropriate and necessary to address future issues concerning utility costs and environmental impacts. Indeed, the use of a third party administrator to develop and administer statewide energy efficiency efforts does not decrease the risk of decreased sales, but probably amplifies it in part because the impacts on a specific utility are hard to trace. Thus, it is reasonable to expect that any significant and meaningful increases in energy efficiency, improved rate designs and customer sited renewable resources will further exacerbate these disincentives.

The use of biennial test years in Wisconsin helps mitigate the potential time lag between when rates are initially set and trued up. But, this does not necessarily offset the magnitude of potential "lost revenues" from substantially increased utility-funded or other entities' initiatives to pursue the policies recommended by the Global Warming Task Force. Indeed, "lost revenues" are difficult to estimate in the first place. While a shorter time lag between when rates are reset can mitigate risk to some degree, the expanded scope and diversity of overall efforts substantially increases the potential magnitude of even short term variances between estimated and actual sales revenue.

While regulation can seek to ensure that actions are taken in the public interest, such efforts are likely to be far more effective and sustainable when a utility's financial interest is aligned with articulated public policy objectives. It is also necessary to look beyond utilities as only regulated entities to recognize their ability to shape their own environment through legislative and other action. It is in the public interest to have utilities support increased public policy objectives rather than seek to limit them.

Wisconsin utilities are not fundamentally unique, but face the same basic disincentives and lack of incentives inherent in traditional regulation to policies and actions that jeopardize their financial interests. As those interests are increasingly subject to being impacted by broader, more diverse and more aggressive policies, the more these disincentives should be expected to become prominent. The objective of better aligning utility financial interests with those of consumers and society is best attained by overcoming the barriers to achieving increased consumer and public benefits so that all parties come out with an improved position. Better aligning the financial interests of Wisconsin utilities with those of consumers and the public interest should not be treated as a "zero sum" game, but one in which appropriate policies achieve making everyone better off.

2. (question only for utilities)

3. If disincentives are removed and the utility elects to spend higher than current amounts on energy efficiency is it best for (a) the utility to develop and implement the programs; (b) should that be done by Focus on Energy; (c) should it be done through a combination of the utility and Focus on Energy; or (d) should it be done by some other entity?

While an interesting and important issue is raised in this question, it is only very tangentially related to the disincentives noted above and the answer is likely to depend on specific circumstances. It is important to recognize that sources of the risk to utility financial interests arise from efforts both inside and outside of the utility such as improvements to building codes or appliance standards. The issue of how best to pursue increased energy efficiency efforts (including where and by whom such efforts are best done) is a distinct topic that should be focused on how to maximize increased cost-effective benefits in a least-cost manner. Clearly, the current Focus on Energy program has been able to use available funds and could use substantially increased utility funds to capture meaningful cost-effective savings and benefits. But, Wisconsin utilities are just as subject to the risks from these savings as they are from their own programs. The issue of how to ensure the best designed energy efficiency programs and administrative and delivery framework in Wisconsin should not be brought into this docket. Those answers involve a very different set of issues than how to best ensure that utilities' financial interests are aligned with the public interest in supporting and facilitating such actions.

4. Do utilities have the resources to develop and implement additional energy efficiency programs?

Utilities in Wisconsin and other jurisdictions have had the resources to develop and implement effective energy efficiency programs. While some utilities may have limited resources to do so at this time, there seems little question that adequate utility infrastructure could be developed if that was desired as is evidenced by past history. Indeed, some utilities with aggressive energy efficiency programs primarily rely on third party contractors and implementers to develop and/or implement their programs. But, it is again important to recognize that the increased risk to utility finances from increased energy efficiency and other desirable public policies is primarily a product of the level, diversity and effectiveness of those effects and the inability to accurately forecast those efforts' impacts, not who makes them. There are many ways that successful programs can be achieved using utility funds but without direct utility control over the development and/or implementation of such programs. Thus, this question is not central to the issues raised in this proceeding.

5. *Should a decoupling mechanism consider only the effects of additional energy efficiency spending or should it also include the effects of other factors such as the economy and weather on actual vs. forecasted sales? If yes, please explain why.*

The issue raised in this question addressed whether a "lost revenue recovery clause" that only seeks to identify the "lost revenues/fixed cost margins" due to a utility energy efficiency program is more desirable than what is typically called "full decoupling" where all factors that may result in actual sales differing from estimated test year sales are adjusted.

A "lost revenue recovery clause" seeks to remove the financial risk to a utility of its own energy efficiency efforts by attempting to determine how much "lost revenues" are due to those specific energy efficiency efforts. However, quantifying the impact of a utility energy efficiency program does not change the impact of other risks faced by a utility whether it is the weather, economy or savings efforts by others. In this regard, it does not offset the "throughput incentive" and is not a method supported by the JPI.

A "full decoupling" mechanism seeks to eliminate the "throughput incentive" in its entirety by removing all nature of risks to the recovery of the level of fixed costs whether subject to the utility's control or not (e.g. weather, economic activity *et al*.). "Full decoupling" addresses all risks that cause a utility to under or over recover its authorized level of fixed costs not only from utility initiatives, but also from other sources such as third party program activity, increased consumer efficiency due to higher prices or improved rates, or a motivation to mitigate the potential of global warming impacts, and the effect of improved codes and standards. It should be noted that a "partial decoupling" mechanism can be designed so that certain risks remain with the utility (e.g. weather) if that is deemed preferable.

There are three attributes of a "lost revenue" adjustment clause that make it less effective in removing the disincentives to a utility for aggressive actions that save substantial energy:

- As noted, it does not remove the "throughput incentive";

- It is limited only to the direct quantifiable impacts of a utility program, thus leaving a barrier to other efforts to reduce usage;
- Its application requires sophisticated (and potentially costly) measurement often resulting in contentious arguments about what a specific utility program actually saved "but for" all other factors.

Thus, a "lost revenues recovery clause" is a limited response with undesirable attributes of its own to the broad disincentives to utility efforts that will not effectively align a utility's private financial interest with the public interest in a meaningful manner.

6. *If you answered yes to Question #5, should it be necessary for a utility to propose additional energy efficiency spending before it could seek recovery of any lost revenues due to other factors?*

The JPI believe that it should be necessary for a utility to commit to additional energy efficiency funding and support for additional energy efficiency efforts such as improved building codes and appliance standards to receive any assured means to recover its authorized fixed costs. It should also be preferable for utilities to adopt improved rate designs and significant initiatives for customer-sited renewable resources.

The reason why such real world actions should be required is because without such actions a "lost revenue recovery clause" or a "decoupling" mechanism becomes little more than a risk reduction clause without significant public and consumer benefits. Decoupling and shareholder benefits can be of value when they increase the aggregate net benefits produced for consumers and the public than would otherwise have been produced and, those net benefits are distributed in an equitable manner among the various stakeholders. That is the justification for mitigating the risk to utilities from public policies such as increased energy efficiency, improved rate design and better customer-sited renewable resource policies. Thus, it is not only the presence of utility support for real world efforts that helps achieve real benefits, but also the magnitude of the real benefits created that result in the increased level of risk for the utility.

7. *If the decoupling mechanism considers only the effects of additional energy efficiency spending, but due to weather, economic other factors the overall sales are equal to or greater than forecast, or if due to other factors the utility is either earning its authorized ROE or is within some range of its authorized return, should it still be allowed to recover lost revenues?*

The JPI understand this question to be should there be some kind of an earning cap where only some portion of fixed costs "lost" due to energy efficiency is ensured to be trued-up. The answer is "no" if the mechanism was instituted to ensure that the utility would aggressively pursue energy efficiency that actually reduces its sales. Under the hypothetical, the utility can earn or over-earn its authorized return for any number of reasons just as it might if there was no "lost revenue recovery" mechanism. By limiting recovery, the signal given is that the presence of the "lost revenue recovery" clause and the energy efficiency program can still result in a utility earning less than they would have without the program and the clause. While it could be argued that this approach would still be better than having no "lost revenue" mechanism at all, it is not a strong response to a strong disincentive to the aggressive pursuit of public interest policies.

8. *Please provide what you believe to be the key components of a decoupling mechanism.*

The JPI believes that the key elements of an effective decoupling mechanism should:

- Effectively address the "throughput incentive";
- Mitigate the risk to utility financial interests from all sources of public policy or private actions to reduce inefficient usage whether undertaken by a utility or some other entity;
- Be easy to administer and to prevent "gaming";
- Be flexible enough to accommodate special circumstances.

The "revenue per customer" decoupling mechanism fits these characteristics the best in the JPI's opinion. This approach is a "fixed cost true-up" approach that allows a utility to recover its authorized gross margins [defined as authorized revenues minus authorized fuel costs] while maintaining the incentive for a utility to be as cost-efficient as possible to maximize its earnings. Because a utility's earning is the difference between gross margins and other costs (such as non-fuel O&M, interest, taxes *etc*.), the mechanism will reduce the volatility of revenues to recover fixed costs and mitigate the risk of under-recovery that would lead to lower earnings. This removes the disincentive to policies and actions that have the effect of increasing the risk of "lost" fixed cost margins by reducing sales beyond that estimated in the test year.

The information needed to apply this approach is readily available in a rate case in the form of allowed revenues divided by the average test year customer count (i.e., "revenue per customer). The allowed revenue per customer remains fixed until the next general rate case (which could occur at any time). The mechanism works by comparing the allowed revenue per customer times the average test year number of customers to the allowed revenue per customer times the actual number of customers during the test year (or whatever true-up period had been established). Any difference between these allowed and actual revenues is reflected as a surcharge or refund to customers in a prospective period.

The "revenue per customer" mechanism can also be fine-tuned as desired to cover all or only some customer classes; address the issue of how to treat new customers and even reflect whether a utility's customer base is increasing on contracting. The JPI believe that this approach is an equitable means to allow greater customer and public benefits to be attained with the support of a utility than is likely to be without such support.

9. Please provide examples of ratemaking mechanisms other than decoupling that could incent utilities to pursue additional energy efficiency spending as a reasonable cost to ratepayers.

Experience, including within Wisconsin, would indicate that the ability to earn on increased energy efficiency or similar policy efforts can be adequate to encourage increased efforts even without decoupling. The Wisconsin Power & Light Company's Shared Savings program has been a long-standing example. The opportunity to accrue earnings that will add to shareholder wealth can be adequate to address the potential level of “lost revenue” risk as well as result in the opportunity to increase shareholder wealth. Shareholder incentive mechanisms can come in various forms in which earnings may be gained by exemplary performance in increasing overall net benefits for customers and society. Rather than enumerate the various designs for such shareholder earnings mechanisms, the document cited in the response to Question 15 (in Chapter 6 particularly) provides a good introduction to such mechanisms.

10. *Should all customer classes be included in any mechanism that is implemented to encourage utilities to promote additional energy efficiency spending? Why or why not?*

Not necessarily. Customer classes can and do present different sets of circumstances for increased energy efficiency and other efforts and often require programs to be designed differently. For example, metering costs for small customers may indicate that inverted rates are an improved rate design, while the presence of more sophisticated metering for larger customers would justify a very different appropriate rate design. There are also different ways as well as issues to overcome customer barriers to increased energy efficiency efforts. For example, Wisconsin has a category of “large energy customers” who can opt for a self-direction program in which their contribution to overall statewide efforts can be applied directly to their own energy efficiency projects. This mechanism attempts to recognize that some customers can be very price sensitive and that the loss of such customers could result in fixed costs being re-allocated to other customers. Energy efficiency, rate design and customer-sited renewable resources are most effective and valuable when customized to be effective under specific facts and situations. Overcoming utility financial barriers to energy efficiency and similar policies is no different.

11. *If the answer to Question #10 is no, should additional energy efficiency programs only be designed to benefit participating customer classes? Why or why not?*

The JPI understand this question to be: should additional energy efficiency programs be limited only to those classes covered by a “lost revenues” recovery or decoupling mechanism? The answer to this question is “no”. As a general principle allocating program costs to the specific customer class eligible to participate in the program is appropriate and equitable. But, all customer classes should be provided effective savings opportunities and, as noted in the response to Question 10, the benefits of allowing “lost revenues” to be recovered must be balanced against the effects as well as the potential nature of the barriers that a specific customer class may have to pursue increased energy efficiency efforts. Improved and increased energy efficiency and similar initiatives whether by utilities or other entities for all customer classes are desirable. But, those efforts should be designed to provide net benefits to those customer classes, not just to utility shareholders.

12. Do you foresee controversy in determining the amount of reduced kWh sales caused by additional energy efficiency spending and the dollar margin on the reduced sales used to determine the under recovered amount to be included in rates? Why or why not?

As noted in our response to Question #5, the greatest opportunity for “controversy” in determining the amount of adjustment to be made is when a “lost revenue recovery clause” is used. This is because one is seeking to determine what the sales and revenues would have been if the energy efficiency actions had not been undertaken (or stated conversely trying to isolate from many potential factors what decline in sales and fixed costs is specifically attributable “but for” the increased energy efficiency program effort). There is an incentive created for a utility to seek to overstate the savings from its program efforts and a corresponding concern for customers to pay for something that they did not receive. Full decoupling methods, such as the “revenue per customer” method supported by the JPI, that adjust for all factors that affect actual fixed costs revenues compared to estimated test year fixed year cost revenues are far less “controversial” in this regard since the calculation for the adjustment are typically straightforward.

A "full decoupling" mechanism does however have the effect of slightly reducing the near term energy efficiency benefits for a utility customer that participates in taking an energy efficiency action. This is the result of the "truing-up of fixed costs" within the decoupling mechanism so that the utility revenues include at least the estimated test year fixed costs. If these costs have been under-recovered in a specific year, the resultant true-up will result in rates increasing slightly for both program participants and non-participants, thereby slightly reducing the participant's near term savings (the participant will still have positive savings). However, assuming that the programs have been well designed, including to allow broad participation, and broad initiatives have been effectively supported, the end result will still be increased net benefits for all customers and the public in the form of reduced future utility costs and environmental impacts. In addition, a "full decoupling" mechanism will also refund dollars to customers when a utility over-recovers its fixed costs due to abnormal weather or other reasons. Over time, it is reasonable to expect that customers will see substantial net benefits (which the Commission may wish to test in a pilot with an adequate term such as three to four years).

Finally, in the short term, certain circumstances could lead to a significant balance under a decoupling mechanism to be recovered from customers that could create a contentious situation. The magnitude and timing of the recovery of "lost margins" can raise concerns. However, there are ways to address such situations in the design of a decoupling mechanism that mitigate the likelihood or impact of such circumstances.

13. *Considering the time lag between the design and implementation of energy efficiency programs and that utilities file regularly for rate reviews, would the following alternative to decoupling be useful in removing disincentives to utilities promoting these programs? For programs that a utility is proposing prior to a rate case filing an estimate of reduced sales would be made and the test year sales forecast would be reduced accordingly. For programs developed and implemented during the utility's biennial period, a decoupling mechanism could be used to adjust the impact of these programs until the next rate case (it would be likely that the lag time in implementing programs would make revenue adjustments fairly small).*

The JPI believe that the test year forecasting approach embodied in the question is what should be done if a decoupling mechanism is adopted or not. But, by itself this may not be adequate to forego the need for a decoupling mechanism in the first year given the potential magnitude of the increased energy efficiency and other efforts that could result in decreased actual sales. The rationale underlying this answer is that since fixed costs including the utility's rate of return are collected on the margin, their recovery is very sensitive to the degree that actual sales and revenues for fixed costs decrease (i.e., lost profit will be greater than the extent of lost sales). Thus, the ability to accurately forecast the expected impacts of diverse sources that could result in actual and estimated test year sales from diverging is only one issue of importance. In addition, it is desirable to accelerate the capture of increased benefits when they are available rather than having a utility attempt to inhibit such efforts if they might be more successful than estimated in the test year (assuming that such control is even possible given the diversity of the efforts to improve efficiency).

Decreasing the time frame between when prices are in effect and when they may be trued-up can mitigate potential risk from reduced sales. But, substantial profit losses could still occur over a limited period of time if substantial activity occurs that reduces sales greater than had been estimated. It is not simply a matter of time that defines the risk but the diversity and magnitude of activities that make estimating impacts difficult that creates the risk as well. There are many factors that can cause even the best estimate of impacts to vary substantially even in a short period like a year.

14. Is revenue decoupling illegal retroactive ratemaking? Why or why not?

The prohibition against retroactive ratemaking is well-established under Wisconsin law.[2] Under Wis. Stat. § 196.37(1), the Commission generally lacks the authority to approve a rate that permits an electric utility to increase its rates to recover for past expenditures.[3] Likewise, the Commission generally lacks the authority to order a

[2] *Kimberly Clark-Corp. v. Pub. Serv. Comm'n*, 110 Wis. 2d 455, 468, 329 N.W.2d 143, 149 (1983).
[3] *Wisconsin's Environmental Decade, Inc. v. Pub. Serv. Comm'n*, 98 Wis. 2d 682, 699, 298 N.W.2d 205, 212 (Ct. App. 1980), *citing Wisconsin Telephone Co. v. Pub. Serv. Comm'n*, 232 Wis. 274, 303, 287 N.W. 122, 137 (1939).

refund or to lower rates for prior over collection in rates approved by the PSC or for imprudency.[4]

To the extent that the Commission concludes that decoupling may involve aspects of retroactive ratemaking, the JPI submit that decoupling does not constitute *illegal* retroactive ratemaking under Wisconsin law. The prohibition against retroactive ratemaking is not absolute, and whether the rule must be applied in a particular instance is determined in consideration of the public policy purposes behind the doctrine.[5] As noted by the courts, "the primary purpose of the public utility laws in this state is the protection of the consuming public."[6] The prohibition against retroactive ratemaking furthers this policy by rewarding a utility's efficiency and protecting consumers from surprise surcharges allocable to the utility's losses in a prior year.[7] Accordingly, the rule ensures fairness, stability and certainty.[8]

Where mechanical application of the prohibition against retroactive ratemaking would not serve the rule's purpose, Wisconsin courts have recognized exceptions to the doctrine. For instance, where an ice storm caused extraordinary losses to a utility, the Wisconsin Supreme Court held that it was proper for the Commission to permit recovery of these past costs in future rates because the losses had been caused by forces outside the utility's control.[9] In such an instance, the Court recognized that application of the retroactive ratemaking prohibition would do nothing to further the goal of ensuring that managers have strong incentives to manage their utilities efficiently, and accordingly permitted recovery for the prior loss.

In reaching this result, the Court relied upon its determination in a prior case in which the Court had permitted a utility to recover in future rates its prior losses on utility equipment that had been "rendered obsolete because an improved method of providing

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[4] *See Friends of the Earth v. Pub. Serv. Comm'n,* 78 Wis. 2d 388, 254 N.W.2d 299 (1977); *Wisconsin Power and Light Co. v. Pub. Serv. Com'n*, 181 Wis. 2d 385, 511 N.W.2d 291 (1994).
[5] *See GTE North Inc. v. Pub. Serv. Com'n*, 176 Wis. 2d 559, 568, 500 N.W.2d 284, 288 (1993).
[6] *Wisconsin's. Environmental Decade, Inc. v. Pub. Serv. Comm'n.*, 81 Wis. 2d 344, 351, 260 N.W.2d 712, 715, 716 (1978).
[7] *Wisconsin Power and Light Co. v. Pub. Serv. Comm'n*, 181 Wis. 2d 385, 402, 511 N.W.2d 291, 297 (1994)(J. Abrahamson dissenting).
[8] *Id.* (citations omitted).
[9] *Wisconsin's Environmental Decade*, 98 Wis. 2d at 698-700, 298 N.W.2d at 211-12.

power was introduced into the service area."[10] In that decision, the Court implicitly recognized that failure to permit such recovery would serve no purpose as the Town's equipment had been prudently purchased but had been "rendered obsolete" due to events beyond its control.

A properly designed decoupling mechanism that furthers adoption of energy efficiency and other measures to assist customers combat higher utility energy prices should not run afoul of the retroactive ratemaking doctrine. First, decoupling does nothing to reduce a utility's incentive to achieve efficiencies. Decoupling only seeks to address whether a utility is receiving revenues sufficient for it to recover its fixed costs on a per customer basis. With decoupling, a utility can and will seek to reduce costs because to do so will increase its profits. In turn, these cost reductions will improve its efficiency and put downward pressure on rates in future rate cases.

Second, decoupling should not run afoul of the retroactive ratemaking doctrine because it seeks to protect consumers by creating the conditions that will lead them to obtaining more tools to combat ever higher energy prices. To protect its revenues, a utility can oppose increased energy efficiency initiatives, innovative rates, development of new load management options and customer-owned renewable generation. It can effect this opposition in its own rate cases and public policy arenas. Decoupling neutralizes this opposition because it ensures that a utility can achieve adequate revenues for its fixed costs despite a decline in sales. Moreover, decoupling actually promotes efficiency in the sense that society will benefit by the adoption of cost-effective ways of reducing utility load which, in turn, will benefit society as a whole in a future, carbon-constrained world.[11]

A decoupling mechanism is readily distinguished from the Commission's proposed fuel rule true-up mechanism contained in its draft revisions to the fuel rule.[12] There, the true-up mechanism, which will adjust future rates to account for prior costs,

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[10] *Wisconsin's Environmental Decade*, 98 Wis. 2d at 699-700, 298 N.W.2d at 212, *citing Town of Milton v. Railroad Commission*, 185 Wis. 294, 295, 201 N.W. 381, 382 (1924).

[11] *A Wisconsin Strategy for Reducing Global Warming, Global Warming Task Force Interim Report* (February 19, 2008) *(*"The objective of these changes [innovative ratemaking approaches] should be to provide long-term customer benefits and maintain a healthy economy.") The report may be found at: http://dnr.wi.gov/environmentprotect/gtfgw/documents/interim_report.pdf.

[12] *See* Notice of Hearing, July 3, 2008, Revisions to Rules on Electric Rate Changes Due to the Cost of Fuel, Docket No. 1-AC-224, PSC REF # 97316

will lessen utility incentives to control their fuel costs to the detriment of the consuming public.

> *15. Are you aware of mechanisms other states use to incent additional energy efficiency on behalf of their utilities that you believe would be successful in Wisconsin? If so, please identify those states?*

The JPI believe that efforts in other states could be helpful in aiding Wisconsin to develop its approaches and mechanisms that best fit the situation in Wisconsin. There is a fairly robust set of literature on these topics especially from the late 1980s to the mid 1990s (prior to industry restructuring) and within the last several years. Rather than recreate a catalog of useful literature available on efforts in other states, following is a citation to a good source document that provides useful information to respond to this question: Aligning Utility Incentives with Investment in Energy Efficiency: A Resource of the National Action Plan for Energy Efficiency (November 2007) prepared by Val Jensen of ICF International especially at pages ES-6 to ES-8 (available for download at www.epa.gov/eeactionplan).

> *16. Does a decoupling mechanism represent a reduction in risk to the utility? If so, should that be reflected in the authorized return on equity?*

"Decoupling" is a mechanism whose purpose is to mitigate financial risk by reducing the volatility of revenues including the recovery of fixed costs collected by a utility. "Full decoupling" typically addresses all of the risks that could result in a difference in estimated test year sales and actual sales by in effect "truing up" the fixed cost revenue requirement so that a utility is ensured to recover its test year level of fixed costs. But, while decoupling reduces financial risk in this manner, it does not guarantee a specific return since it only addresses revenues (i.e., a utility still has an incentive to have actual costs lower than estimated test year costs since it is allowed to "over-earn" under these circumstances under traditional regulation).

The effect of a "decoupling mechanism" on overall financial risk depends on the circumstances in which it is applied. For example, if a utility seeks to aggressively increase its support for energy efficiency by tripling its cost contribution, revise its rate design to promote increased conservation by increasing the "fixed costs" in the volumetric portion of rates, promote new building and appliance codes, and undertake aggressive efforts to promote customer-sited renewable resources, the financial risk to the utility, all else equal, would be higher than if it sought decoupling without any of those actions. However, if "full decoupling" is applied, it will mitigate financial risk to the utility from other sources, such as weather and the economy, as well as increased energy efficiency, rate design and other policies. Therefore, the issue is what is the net effect on financial risk from the increased risk caused by the new initiatives and the decreased risk of decoupling compared to the otherwise authorized return.

Also, an adjustment to ROE is not the only way to reflect any net change in risk from a decoupling mechanism. There is a reasonable argument that "decoupling" would benefit bondholders more than shareholders by decreasing the volatility of revenues. This would result in improving earnings available for fixed times-interest coverages that would support a higher bond rating for the utility. A higher bond rating should result in lower cost bond funds to the utility or less equity in the capital structure. Such a financial benefit should be passed on to the utility's customers.

17. *What process should the Commission use to establish the parameters of ratemaking approaches that promote energy efficiency; i.e., should the Commission approve utility-specific plans or establish guidelines for implementation in rate cases?*

The Joint Public Interveners recommend that utility-specific mechanisms be adopted only in rate cases so the specific facts and circumstances can be considered. It also ensures that all interested parties can participate in a contested case proceeding. However, it would be useful in a proceeding such as this one for the Commission to outline the scope of potential mechanisms that it might entertain as well as to provide insight on the issues of importance from the Commission's perspective on the potential need or desirability of such mechanisms.

18. *Are there important differences between gas and electric utilities to be considered when designing an incentive mechanism?*

Yes and no. Natural gas utilities have a higher proportion of ‘fixed costs” in the short term in rates and for some customer classes may have a declining use per customer that may make it more difficult to estimate actual versus expected test year impacts. Substantially increased energy efficiency, rate design or other efforts in these circumstances would also be expected to have an even more acute potential impact on financial results for those utilities. However, the general framework of issues and potential responses would be fairly common across utilities.

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Respectfully submitted,

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